



## 2011 Year in Review

December 31, 2011

### *SUMMARY & HIGHLIGHTS*

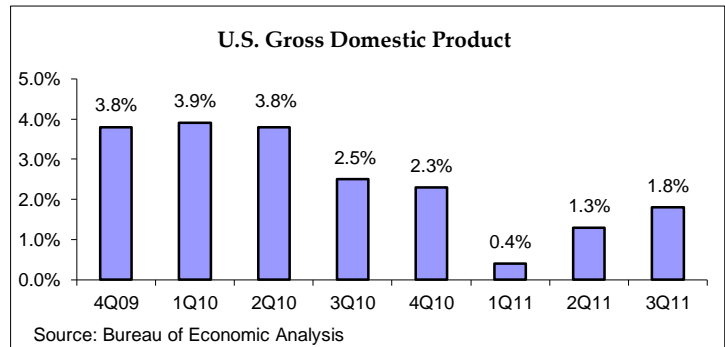
- 2011 was a transition year in the U.S. economy. It was also a frustrating year as the economic recovery has been slow to materialize. We anticipate that fourth quarter 2011 GDP will show a nice gain in the area of 3.0%, but economic growth in the first half of 2012 will be difficult. Housing will remain a drag, Europe will continue to create headwinds and government spending will be reduced.
- There is some growing optimism for better economic growth in the coming quarters, based on improving macroeconomic data. The unemployment rate (8.5%) is beginning to decline and it is anticipated that new job creation will improve modestly in 2012.
- 2011 proved to be another volatile year for the stock market and, in the end, performance was lackluster. The S&P 500 finished flat for the year at 1,258 while the Dow Jones Industrial Average gained 5.5% to end at 12,218.
- As we move into 2012, stocks are anticipated to move moderately higher throughout the year. The major risk to the market remains the European debt crisis and its contagion effect on the global economy.
- Throughout 2011, the Federal Reserve was in control of the yield curve. In this post crisis environment, U.S. policy has been to lower interest rates. Not only were domestic economic policies affecting interest rates, but the crisis in Europe also caused capital to flow into U.S. Treasuries. As a result, bonds drastically outperformed equities in 2011 as the 10 year T-Note returned 17.0% vs. the meager 2.1% gain in the S&P 500 Total Return Index.
- Looking ahead, 2012 should not deviate too much from 2011 in the bond market. The Fed is committed to keeping rates low and the election will cause policy makers and investors to do only the bare minimum.

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## GENERAL OVERVIEW

### U.S. Economy

2011 was a transition year in the U.S. economy. It was also a frustrating year as the economic recovery has been slow to materialize and has not mirrored economic recoveries in the past. The reason is that the housing/financial crisis of 2008/9 was far worse than other downturns in recent history and it has taken more stimulation and a longer time period to see real improvement. Consumers, who account for 70% of GDP, have been burned badly by the housing crisis, high unemployment and severe losses on their investments. Thus, consumer spending has contributed very little to GDP growth. On the other hand, the cheap dollar has resulted in good export demand for American products and has pulled industrial companies into a leadership role in the economy. Global demand has been good as emerging nations are not burdened with the large scale debts that exist in Western nations. The emerging middle class in many global emerging nations is a strong economic and political force that is just beginning to be felt.



Last year began on an upbeat note and continued for several months until the Japanese earthquake hit, followed by the devastating tsunami that caused a giant nuclear reactor to become crippled resulting in a global emergency. This combination of events had vast implications for the global industrial supply chain that disrupted production of many critical products around the world, most notably automobiles. The disruption was significant and was not rectified until the end of last year.

After that, the "Arab Spring" developed from seemingly minor events in the Middle East and grew to result in major regime changes in Egypt and Libya along with on-going demonstrations for more democracy in Syria and other areas of the region. As a result of the political events in the Middle East, oil prices rose to \$114. In our opinion, the recent developments in Iran create another threat to world peace and the global investment markets. It appears Iran is committed to the development of a nuclear weapon and nothing has dissuaded them from this goal.

Over the summer, problems in Greece came to light that called for a bailout from the EU and the IMF. There was also civil unrest that resulted in a loss of confidence in the socialist party and its leader George Papandreou. He later resigned and a new government was installed to address the economic and financial crisis. In typical fashion, the EU answer to the Greek crisis was to apply more debt to this fragile economy to buy time and organize a longer term EU supported solution. Other peripheral EU countries remain under siege (this includes Great Britain, a non-member) and the EU banks are particularly vulnerable along with sovereign nations, such as: Italy, Spain, Portugal and Ireland.

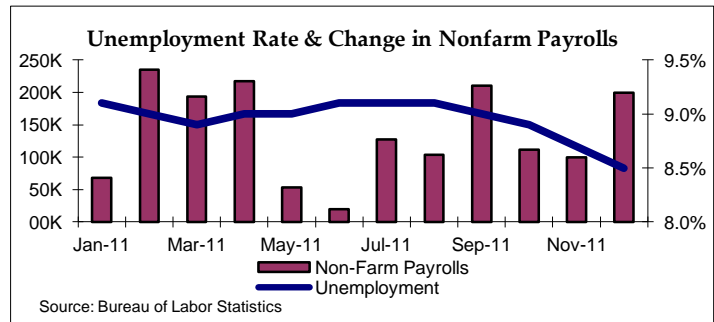
In the U.S., Congress struck a deal to raise the debt ceiling to avoid a default; however, Standard & Poor's downgraded the U.S. credit rating from AAA to AA+. About the same time as the U.S. debt downgrade, gold hit a record high of about \$1,900. While this was a humiliating blow, the bond market took the downgrade in stride as rates actually declined due to the European crisis. Unfortunately, Congress has not yet learned a lesson. The President appointed a bi-partisan commission to recommend substantial spending cuts in order to address the mounting debt/deficit crisis. This commission failed to agree on any concrete proposal and the negotiation

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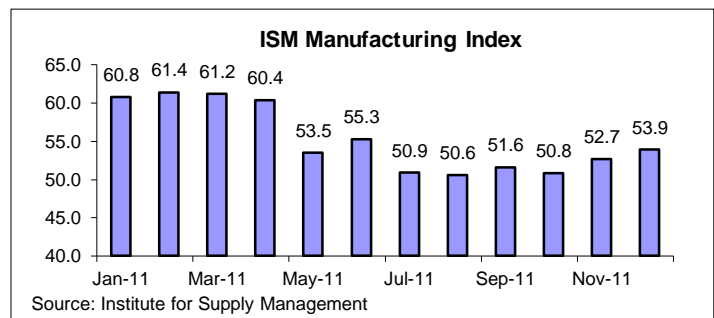
continues. Prior to the holidays, Congress worked out a two month agreement to extend the payroll tax cuts and unemployment insurance benefits as a longer term proposal could not be agreed upon. Congress and the Obama Administration will resume talks after the holidays to address the larger deficit and tax issues.

The “Occupy Wall Street” movement began early last fall to point out the excesses of Wall Street and the big money institutions that apply so much pressure on Washington. The OWS movement is angry that the banks are not being held responsible for the housing and financial crisis that hurt so many citizens while gaining trillions of dollars in government bailouts. President Obama added fuel to the fire by pointing out in his campaign speeches that the top 1% of earners is not paying its fair share in taxes. All in all, this social bifurcation theme has continued while the OWS movement has quietly died down.

Looking ahead, there is some growing optimism for better economic growth in the coming quarters, based on recent improving macroeconomic data. Payroll gains picked up in the first part of the year but then tailed off over the summer while the unemployment rate stagnated around 9.0%. Just last week 200,000 new jobs were reported in December while unemployment fell slightly to 8.5%. Still a far cry from pre-financial crisis levels but at least the trend is moving in the right direction.



In addition, the ISM Indexes for manufacturing and services both showed solid results in December of 53.9 and 52.6, respectively. A reading above 50 signals economic expansion while a reading below 50 signals economic contraction. Like the payroll gains, the ISM Manufacturing Index declined over the summer but has trended higher in recent months. So, while a month or two of improving economic news does not a year make, there is clearly some progress being made.



How well will the overall U.S. economy do in 2012? Our view is that the economy will again muddle through another transition year, similar to 2011. We anticipate that fourth quarter 2011 GDP will show a nice gain in the area of 3.0%, but economic growth in the first half of 2012 will be difficult. Housing will remain a drag, Europe will continue to create headwinds and government spending will be reduced. From a global perspective, we see improving strength from many emerging market countries that will somewhat off-set the slowdown in the western countries. We do not expect a double dip in the economy, but anticipate a year of moderate growth that will gradually build-up strength as the second half of 2012 unfolds.

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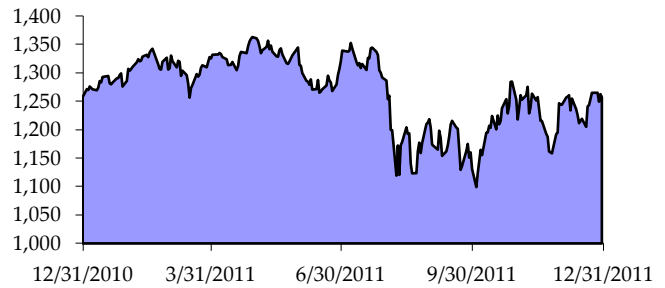
## EQUITY MARKET OVERVIEW

### Equity Market Performance

2011 proved to be another volatile year for the stock market and, in the end, performance was lackluster. The S&P 500 finished flat for the year at 1,258 while the Dow Jones Industrial Average gained 5.5% to end at 12,218. Solid company fundamentals were a secondary thought as much of the market action was driven by macroeconomic events with day to day fluctuations driven by headline news out of Europe and Washington. Europe's evolving financial crisis and the inability of Congress to tackle our deficit issues here in the U.S., whipsawed stocks over the year leaving investors rather skittish.

**S&P 500 Performance**

12/31/2010 - 12/31/2011



Source: Yahoo Finance

The year started out strongly as companies continued to beat earnings expectations and the economic recovery seemed to progress, albeit moderately. Stocks hit a speed bump in March as the tsunami and nuclear disaster hit Japan and concern over the global economic recovery began to take root. The true "straw that broke the camel's back," as they say, came over the summer as the Greek debt crisis unfolded. European officials were left scrambling to prevent a Greek default and the possible contagion effect on other EU countries. As a result, the S&P 500 fell 17% from the end of June through early August. However, the S&P 500 was able to bounce back strongly in October and limped through the final months to end the year right where it started.

Of the major U.S. indices, The Dow Jones Industrial Average returned 8.4% while the S&P 500 Total Return Index gained 2.1%, including dividends. Small cap stocks as measured by the Russell 2000 returned -5.5% after an exceptionally strong performance in the prior year. If 2010 was the year for small caps, 2011 saw the return of large cap dividend paying stocks. Given the global economic turmoil and paltry yields on government and corporate bonds it seems investors gravitated toward high quality dividend paying stocks to supplement the meager income generation of bonds.

Equity Performance	2008	2009	2010	2011
Dow Jones Industrials	-31.8%	22.6%	14.0%	8.4%
S&P 500 Total Return	-37.0%	26.5%	15.1%	2.1%
Nasdaq	-40.5%	43.9%	16.9%	-1.8%
Russell 2000	-34.8%	25.2%	25.3%	-5.5%
Wilshire 5000	-38.7%	26.5%	15.6%	-1.4%
MSCI-EAFE	-43.4%	31.8%	7.8%	-12.1%
MSCI-Emerging Markets	-53.3%	78.5%	18.9%	-18.4%

Source: Portfolio Center

Solid dividend payers like McDonalds (+30.7%), Philip Morris International (+34.1%), Kinder Morgan Energy (+20.9%) and Bristol-Myers Squibb (+33.1%) provided investors with hefty returns for the year.

International equities lagged their domestic counterparts as the MSCI EAFE and MSCI Emerging Markets indices returned -12.1% and -18.4%, respectively. European equities were hit hard as the European debt crisis arose and government officials fought to implement austerity programs and other measures to prevent a full blown collapse of the financial markets. The economic implications of such programs caused emerging market stocks to sell-off in sympathy given that the European banks have been big lenders to developing countries helping to fund their growth in recent years.

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Investors gravitated toward the more defensive sectors in 2011 as Utilities (+14.8%), Consumer Staples (+10.5%) and Health Care (+10.2%) provided the best performance after underperforming in 2010. Conversely, Materials (-11.6%) and Industrials (-2.9%) were two of the weakest performing sectors in 2011 after having solid returns in 2010, proving once again, past performance is not indicative of future results. Financials (-18.4%) fared the worst as bank stocks continued to suffer the effects of the financial crisis as investors questioned the strength of the banks' balance sheets and the long term earnings power of the banking model. The Information Technology (+1.3%) sector was only able to squeak out a slight gain for the year despite huge gains in Apple (+25.6%) and transaction processors Visa (+44.3%) and MasterCard (+66.4%). Apple's iPhone and other smartphones running Google's Android operating system have decimated other handset providers such as Research in Motion (-75.1%), which sells the Blackberry, and Nokia (-53.3%).

S&P 500 Sector Performance	2008	2009	2010	2011
Consumer Discretionary	-34.7%	38.8%	25.7%	4.4%
Consumer Staples	-17.7%	11.2%	10.7%	10.5%
Energy	-35.9%	11.3%	17.9%	2.8%
Financials	-57.0%	14.8%	10.8%	-18.4%
Health Care	-24.5%	17.1%	0.7%	10.2%
Industrials	-41.5%	17.3%	23.9%	-2.9%
Information Technology	-43.7%	59.9%	9.1%	1.3%
Materials	-47.1%	45.2%	19.9%	-11.6%
Telecom Services	-33.6%	2.6%	12.3%	0.8%
Utilities	-31.6%	6.8%	0.9%	14.8%

Source: Portfolio Center

## S&P 500 Earnings

S&P 500 operating earnings have been adjusted downward somewhat in recent months but should still hit an all time high of \$97 in 2011 resulting in a healthy 15.8% increase over 2010. Interestingly, the S&P 500 ended 2011 at the same level it ended 2010 despite the solid earnings growth as macroeconomic events captured much of investors' attention throughout the year. Looking out to 2012, analysts are predicting earnings to rise 10% to \$107. At this level, the S&P 500 is trading at 11.7x making stocks rather attractive when compared to the extremely low yields bonds are currently providing. The next month could be rather telling as companies wrap up 2011 by reporting fourth quarter earnings and providing an outlook for the year ahead.

S&P 500 Sector Earnings Estimates	2011E	YoY Chg	11 P/E
<b>S&amp;P 500</b>	<b>\$97.02</b>	<b>15.8%</b>	<b>13.2x</b>
Consumer Discretionary	\$20.49	12.6%	15.2x
Consumer Staples	\$21.30	9.5%	15.8x
Energy	\$50.07	42.2%	10.7x
Financials	\$16.05	8.3%	11.2x
Health Care	\$31.68	9.6%	12.9x
Industrials	\$20.95	13.8%	14.2x
Information Technology	\$31.06	18.3%	13.4x
Materials	\$17.29	29.7%	12.6x
Telecommunication Services	\$7.07	-3.9%	18.4x
Utilities	\$12.49	1.2%	14.4x

Source: Standard & Poor's as of 1/3/12

As we move into 2012, stocks are anticipated to move moderately higher throughout the year. The major risk to the market remains the European debt crisis and its contagion effect on the global economy. That being the case, volatility could remain elevated as stocks will most likely continue to fluctuate on the headlines out of Europe and the rumblings in Washington. If Europe can make progress throughout the coming months and piece together a meaningful plan to prevent further deterioration in its financial system, investors will hopefully turn their attention back to the improving economic data here in the U.S., solid company fundamentals and the relative value that stocks currently offer.

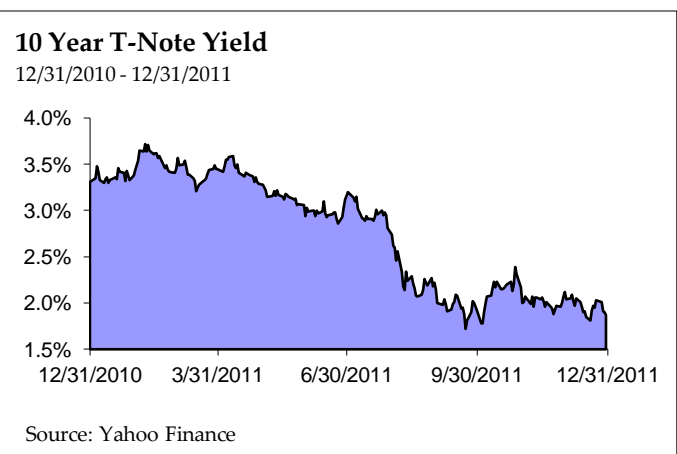
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## BOND MARKET & INTEREST RATE OVERVIEW

### Bond Market Performance

Throughout 2011, the Federal Reserve has been in control of the yield curve. In this post crisis environment, U.S. policy has been to lower interest rates (to zero) and try to inflate asset prices in order to stimulate investment spending, drive capital into equities along with improving consumer confidence. So far, this policy has been slow to reach its objectives, due to the deleveraging across the globe, high unemployment, the on-going housing crisis and loss of confidence in the government's ability to lead the country. The Fed has certainly done its part and has further committed to maintaining this easy money policy through 2013, pledging to use unconventional methods such as QE2 and Operation Twist to ensure the U.S. economy does not sink into a recession. It has no doubt been frustrating for the Fed, as well as government policy officials, as it has taken so long for economic growth to materialize. However, the many headwinds that exist including the European banking and sovereign debt crisis have certainly delayed and complicated things.

The best view of interest rates comes from the graph of the 10 year Treasury Note yield that shows how interest rates started out the year around 3.30%. As the year unfolded, the policies of QE2 began to drive rates lower before stabilizing in September at the 2.0% level. Not only were domestic economic policies affecting interest rates, but the crisis in Europe also caused capital to flow into U.S. Treasuries. As a result, bonds drastically outperformed equities in 2011 as the 10 year T-Note returned 17.0% vs. the meager 2.1% gain in the S&P 500 Total Return Index.



Ironically, investors were piling into U.S. bonds at the same time the rating agencies were downgrading U.S. debt from AAA to AA+. This occurred when Congress could not agree on a way to authorize an increase in the debt limit in order to avoid a government shutdown last fall, to say nothing of the government's inability to tackle debt, spending and tax issues needed to address the mounting crisis. Unfortunately, western democracies (Europe and the U.S. particularly) do not act proactively, but need a crisis before addressing these issues.

Bond Market Performance	2008	2009	2010	2011
90 day T-Bills	2.1%	0.2%	0.1%	0.1%
10 year T-Notes	20.3%	-9.9%	8.1%	17.0%
Corporates	-3.3%	17.1%	8.9%	8.8%
Agencies	14.8%	4.1%	8.1%	10.5%
GNMA Bonds	8.5%	5.8%	7.1%	8.4%
TIPS	-4.5%	22.5%	11.3%	23.2%
High Yield Bonds	-29.1%	66.6%	16.2%	5.3%
Municipal Bonds	-2.9%	14.9%	2.7%	12.1%

Source: Portfolio Center

Like the VIX for stocks, the credit spread is the best measure of risk for the bond market as this spread measures the preference of investors for corporate bonds compared to less risky government securities. Credit spreads were low in the early months of 2011, but as nervousness grew over the European crisis, credit spreads began to widen out in August. Spreads peaked in October at about 1.5% and gradually settled back to the current level of about 1.35%.

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The debt, spending and budget problems have not escaped state and local governments either, as there have been a number of high profile defaults in 2011. However, the market for municipal bonds regained its appeal to investors in the second half of last year, having also experienced a crisis of confidence during the height of the European crisis. A noted Wall Street analyst predicted that the mounting fiscal imbalances with state and local municipalities would balloon in the billions of dollars, causing hundreds of bond issuers to default. So far, this prediction has not come true. However, it is clear that many serious budget deficit problems exist around the country.

Another interesting development in the bond market this year occurred in September when the Fed announced another extraordinary program named "Operation Twist". This latest policy was designed to alter the shape of the yield curve by driving down long term rates. This was accomplished through the sale of shorter term bond holdings already owned in the Fed's portfolio and buying longer dated maturities. The U.S. is fortunate to enjoy low long term interest rates during this time of fiscal uncertainty as compared to the punitively high rates the European countries must pay.

Looking ahead, 2012 should not deviate too much from 2011 in the bond market. The Fed is committed to keeping rates low and the election will cause policy makers and investors to do only the bare minimum. Europe is the key to tranquility in U.S. markets. If the EU and the IMF along with the ECB come together to assist in the debt management of banks and sovereigns during this next year, the bond markets will remain relatively calm. However, if Germany digs in its heels and does not assist its neighbors, another crisis could unfold. Right now Europe is whistling past the graveyard in hopes that capital will continue to flow into it institutions without demanding higher risk premiums during this time of crisis and transition to growth. We see the 10 year Treasury Note yield remaining low in the 1.5% to 2.5% range. So far, Europe's mess has benefitted the U.S. as capital has fled into the dollar helping keep domestic rates low and the dollar sound.

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